Supreme Court, U.S.
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No.

IN THE

Supreme Court of the United States

INFORMATION SYSTEMS & NETWORKS CORPORATION,
PETITIONER

v.

UNITED STATES

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Does the decision below denying petitioner the right to be reimbursed for the state income taxes it paid as a result of performing its contract with the government subvert the purposes of the Federal Acquisition Regulations, the Small Business Act, public policy and Congress' intent that government not penalize through its reimbursement scheme those who elect to organize themselves as a Subchapter S corporation?

2. Does the decision below run afoul of the policies of Congress and the Executive Branch which foster the robust participation of small businesses generally and Subchapter S corporations in particular in the Nation's commerce, including the federal government's procurement of goods and services from vendors such as the petitioner?

3. Is the constitutional guaranty of the equal protection of the laws undermined by the decision below which applies the Federal Acquisition Regulations differently for no reason rooted in law to those like the petitioner who as a small business elects to organize itself as a Subchapter S corporation?

RULE 29.6

Petitioner is a privately held corporation and no publicly held company owns more than 10% of Petitioner's stock.

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OPINIONS BELOW

The published opinion of the United States Court of Appeals for the Federal Circuit in *Information Systems & Networks Corporation v. United States* (C.A. Nos. 04-5151 and 5154),437 F.3d 1173, U.S. App. LEXIS 2820(Fed. Cir. 2006), decided February 6, 2006, reversing the United States Court of Federal Claims which allowed the petitioner to recover as part of its costs under its reimbursement contract with the respondent United States the state income tax payments its sole shareholder paid as part of the business activities related to this contract, is set forth in the Appendix hereto(App. 1-10).

The published opinion of the United States Court of Federal Claims in *Information Systems & Networks Corporation v. United States*(Docket No. 98-663C), 48 Fed. Cl. 265(2000), decided November 30, 2000, allowing the petitioner to recover as part of its costs under its reimbursement contract with the respondent United States the state income tax payments its sole shareholder paid as part of the business activities related to this contract, is set forth in the Appendix hereto(App. 11-30).

The unpublished order of the United States Court of Appeals for the Federal Circuit in *Information Systems & Networks Corporation v. United States* (C.A. Nos. 04-5151 and 04-5154), decided and filed April 14, 2006, denying the petitioner's timely filed combined petition for panel rehearing or for rehearing *en banc*, is set forth in the Appendix hereto(App. 31-32).

JURISDICTION

The decision of the United States Court of Appeals for the Federal Circuit reversing the Court of Federal Claims' decision allowing the petitioner to recover its state tax payments as part of the reimbursable costs under this contract with the United States, was entered on February 6, 2006; its further order denying the petitioner's timely filed combined petition for panel rehearing or for rehearing *en banc* was filed and decided on April 14, 2006; on July 3, 2006, the petitioner timely applied to The Chief Justice of this Court for an extension of time to file its petition for certiorari (Docket No. 06A25); and on July 11, 2006, The Chief Justice granted the petitioner's motion, extending the time to file its petition for certiorari until August 14, 2006(App.1;31).

This petition for writ of certiorari is filed within the time limits prescribed by the Chief Justice in Docket No. 06A25, allowing the petitioner's application for an extension of time to file this petition.

The jurisdiction of this Court is invoked pursuant to the provisions of 28 U.S.C. Section 1254(1).

RELEVANT PROVISIONS INVOLVED (see appendix)

STATEMENT

The petitioner Information Systems & Networks Corporation ("the petitioner" or "ISN") is a corporation duly organized under Subchapter S of the Internal Revenue Code, 26 U.S.C. Sections 1361-1379. Such so-called "S corporations" are small businesses in

corporate form which have fewer than 75 employees, 26 U.S.C. Section 1361(b)(1)(A), and often have a sole shareholder. In fact, during the years 1985 through 2000, INS' sole shareholder was Ms. Roma Malkani.

In electing to proceed in business as an S corporation, INS was taking advantage of the "tax neutral" provisions which attend such corporate status. As Congress provided, when a small business such as INS decided to incorporate as an S corporation, it incurred the same tax liability on its income whether the business incorporated or not. Subchapter S accomplishes this by eliminating the "double taxation" that usually attends corporate income from a normal or "C" corporation . See 26 U.S.C. Section 1363. With "C" corporations, the corporate entity must pay income taxes on its own income and then when it distributes after-tax income to its shareholders, those shareholders must also pay personal income tax on that source of income, a "double taxation."

With S corporations, however, Congress has provided that no income tax accrues to the corporation; instead, the corporation's income is "passed through" to the shareholders and is attributed to the shareholders' personal income tax liability in pro rata amounts. 26 U.S.C. Section 1366. Most States have taken advantage of the option of recognizing the federal S designation by aligning their own tax codes with the federal Internal Revenue Code in order to acknowledge and allow this "pass through" of income tax liability from the corporation to the shareholder(s), taxing only the shareholder(s) for their personal income tax liability in pro rata amounts.

In the 1980's and early 1990's, the petitioner and the respondent United States ("the respondent" or "the government") entered into several cost-reimbursement contracts. As explained in 48 CFR Section 16.301-1, where the cost cannot readily be ascertained at the time of contracting, these types of contracts between the federal government and a private contractor provide a cost ceiling for the work to be performed and permit the government to pay up to that ceiling amount for allowable incurred costs of the contractor for the contract work.48 CFR Section 16.301-2.

During its performance of a cost-reimbursement contract, the contractor incurs direct costs in the form of material, labor, equipment, etc. and indirect costs such as taxes, rental space, insurance, etc. Generally, both direct and indirect costs generated by the contract's performance are allowable if they are reasonable, allocable to the contractor's performance of the contract, founded on generally accepted accounting principles, within the terms of the contract and not otherwise prohibited. 48 CFR Section 31.201-1 and 2. Once performance is complete, a contractor is paid for its indirect costs by requesting reimbursement for them via an "indirect rate proposal." The proposal requests that these costs be included in a so-called "rate pool." The government audits the proposals, determining whether the costs stated by the contractor are allowable within the terms of 48 CFR Section 31.201-1 and 2, and ultimately pays the contractor for its allowable costs according to the rates established by the contract.

The dispute giving rise to this controversy began when the petitioner submitted indirect rate

proposals for FYs 1985 through 1991, proposals which included a request for reimbursement of state income taxes paid for each of those years within its general and administrative expense rate pool. In support of its request for reimbursement of the state taxes it had paid, INS asserted that the Federal Acquisition Regulations, especially 48 CFR Section 31.205-41(a)(1), intended to include such tax reimbursement within its framework; that there was a valid, binding agreement between INS and its sole shareholder, Ms. Malkani, which obligated INS to reimburse her for the state income taxes she paid (to the State of Maryland) as a result of the "pass through" nature of the income earned by this S corporation, thereby creating a valid, reasonable cost to INS in the performance of its contract with the government; and that other S corporations had been reimbursed for state income taxes in this manner.

All of the state income taxes for which the petitioner has sought reimbursement fron the government were imposed in States which acknowledge and allow this "pass through" of income tax liability from the corporation to the shareholder(s), taxing only the shareholder(s) for their personal income tax liability in pro rata amounts, as under the Internal Revenue Code. The petitioner subsequently submitted rate proposals, including requests for state income tax payments, for each fiscal year up to and including 2000.

Except for one year, the government's audit agency (the Defense Contract Audit Agency or "DCAA"), which processed the petitioner's proposals, denied INS' claims for reimbursement of the state income taxes it paid for these years as unallowable.

DCAA based its decision on the fact that INS was an S corporation and therefore was not subject to state income tax:

> The contractor is a Sub-Chapter S Corporation. As such, with few exceptions, the corporation is not taxed by the state on its income; rather the income flows to the stockholders who pay tax on their personal income tax returns. Thus, this is a personal tax expense to the shareholders. The state income taxes of individuals are not allocable to the company, as described in [48 CFR Section] 31.201-4, determining allocability, and therefore are not part of the contract costs, directly or indirectly.

(App. 15).

This dispute continued until April 16, 1998, when the government's Contracting Officer denied INS' claims for the reimbursement of the state income taxes it paid and ordered the petitioner to repay the government for earlier reimbursements it deemed unallowable costs.

On August 18, 1998, the petitioner appealed the Contracting Officer's decision to the United States Court of Federal Claims pursuant to the provisions of the Contract Disputes Act of 1978, 41 U.S.C. Section 609(a)(1). It asked the court to declare that when Ms. Malkani paid state income taxes on its behalf as the sole shareholder of this S corporation, it was a reimbursable, allowable cost under the Federal Acquisition Regulations and therefore should have been included in its indirect rate cost pool for all the contracts

performed by the petitioner for the government. The government counterclaimed asking for the return of its previous reimbursements of a portion of the state income taxes paid by INS.

Upon cross motions for summary judgment, the Court of Federal Claims, Futey, J., first reviewed all of the pertinent provisions of the Federal Acquisition Regulations, especially 48 CFR Section 31.205-41, addressing whether the payment of taxes could be allowable costs entitled to reimbursement in this context(App. 18-19). As the motion judge concluded, those provisions of the Federal Acquisition Regulations specifically addressing how the payment of taxes should be considered for purpose of determining whether such tax payments are "costs" to be reimbursed unmistakably provide that certain Federal, state and local taxes are allowable if they are "are required to be and are paid or accrued in accordance with generally accepted accounting principle" but that if the contractor "is exempt from a certain tax liability...and still proceeds to pay such tax, that tax expenditure is not allowable"(App. 19 citing 48 CFR Section 31.205-41(a) and (b)(3)).

The petitioner argued that Subpart 31.2 of the Federal Acquisition Regulations by its own terms applies to all "commercial organizations," including Subchapter S Corporations, and there are no provisions justifying different treatment of this entity in determining whether state taxes are allowable costs(App. 19). Moreover, it contended that Ms. Malkani had to pay the state a personal income tax as a result of this corporate income; that it was required by agreement to reimburse Ms. Malkani, its sole

shareholder, for this expense; and that such expense was reasonable and allocable because "it was necessary to maintain its [corporate] charter [in the State] and therefore its ability to continue performing work on its contracts with the government"(App. 19-20). The government argued that since INS did not have to pay state income tax in the first instance, its claims for reimbursement are neither allowable under 48 CFR Section 31.205-41(a) and (b)(3), nor reasonable or allocable under the general provisions regulating reimbursement(App. 20).

Judge Futey, however, reasoned that the petitioner's payment of State taxes even though made in the form of reimbursing Ms. Malkani for the State personal income tax she was compelled to pay on account of this corporate income, was an allowable and therefore reimbursable cost. As he saw it, although INS is technically "exempt" from paying state income taxes on its corporate income because of its S corporation status, it is *not* an exemption in the ordinary sense of that term, i.e., the complete absence of a duty to pay taxes such as when a tax abatement occurs(App. 21-22;28-29). Instead, the petitioner is relieved of paying State income tax only because its duty to do so *has not been extinguished but merely transferred* to another entity, its sole shareholder Ms. Malkani, as a result of the "pass through" provisions which characterizes this corporate form as mandated by Congress(App. 21-22). Thus the motion judge concluded that the petitioner, "as an S corporation, is not relieved of state tax liability, but is simply required to pass its liability on its corporate income to Ms. Malkani"(App. 22).

As the motion judge concluded, nothing in the Federal Acquisition Regulations requires that any specific part of a corporation pay the applicable State income taxes(App. 22). Instead, it clearly provides that State taxes which are required to be paid and are paid constitute allowable costs; and because the State taxes here were required to be paid and were paid and "because the tax liability on the corporate income was not subject to abatement or reduction, the state income taxes claimed by the [petitioner] for reimbursement are allowed under the Taxes Provision [of the Federal Acquisition Regulations]"(App. 22).

In a footnote, Judge Futey reasoned that the language forbidding reimbursement when the contractor is "exempt" from the state tax was intended to avoid a "double recovery" by a contractor who is reimbursed by the government for taxes it erroneously paid but does not owe and thereafter receives a refund of the tax from the taxing authorities resulting in a double recovery(App. 29). However, as he noted, there is no danger of a double recovery here because "no refund is available from the state tax authority...[and] the taxes were not erroneously or mistakenly paid but were in fact required to be paid"(App. 29).

In addition, the lower court thought that its interpretation of the Federal Acquisition Regulations to find that the taxes here were allowable costs comports with their general intent not to deny reimbursement to business entities simply because of their tax election or corporate structure(App. 22). Nor does any language in the Internal Revenue Code support the proposition that an election to do business as a Subchapter S corporation with the characteristic of

pass-through taxation will cause it to lose out on reimbursement due to its tax election(App. 22). As it observed, neither the Federal Acquisition Regulations nor Subchapter S of the Internal Revenue Code state that an S corporation is only allowed one type of tax relief, either pass-through taxation or cost-reimbursement(App. 22). As it noted,

> S corporations are small businesses and their corporate structure is meant to help, not hinder, the growth and health of these businesses. It is the general intent of the [Federal Acquisition Regulations] to aid and encourage small businesses as well. [Moreover,] if the Taxes Provision does not allow reimbursement for state income taxes for S corporations, such corporations will most likely change their tax election to C corporation status in order to benefit from the cost reimbursement available from the Taxes Provision. This change in election would cause these government contractors to be taxed at the higher C corporation rates, and therefore the amount the federal government will be required to reimburse will be higher as a result.

(App. 12;29-30). Especially where the S corporation has reimbursed its sole shareholder for the state tax payments which it incurred and which she made on its behalf and where other S corporations previously have been reimbursed for such payments, the government "is obligated to reimburse [ISN] for this transferred pass-through tax expenditure"(App. 23).

Finally, Judge Futey rejected the idea

propounded by the government that the two tax liabilities associated with an S corporation's pass-through income are separate and distinct and that ISN has no basis for requesting reimbursement for the tax expenditures of Ms. Malkani(App. 23-25). His review of the tax codes of the relevant States showed that the relationship between an S corporation and its shareholders is an intermingled, intertwined one for state tax purposes, i.e., *both* the S corporation and its shareholders are "very much" obligated to ensure that state income taxes generated by corporate business are paid(App. 25).

The lower court therefore granted the petitioner's motion for summary judgment, denied the government's cross motion for the same relief and ruled as a matter of law that the Taxes Provision of the Federal Acquisition Regulations (48 CFR Section 31.205-41) allows an S corporation to be reimbursed for the costs associated with the payment of state income tax taxes incurred on its corporate income in the course of performing its cost-reimbursement contract with the government (App. 25). In a ruling of July 21, 2004, Judge Futey determined after a trial that the petitioner was entitled to reimbursement from the government for the applicable years between 1985 and 2000 in the amount of $1,133,176.00.

The government appealed summary judgment ruling to the court of appeals for the federal circuit and on February 6, 2006, the court, in an opinion by Frost, J., reversed Judge Futey, ruling that he had improperly interpreted the Taxes Provision of the Federal Acquisition Regulations, 48 CFR Section 31.205-41(App. 1-10). According to the court of appeals, while

the language of the Taxes Provision makes clear that the term "exemption" means freedom from taxation in whole or in part and may include a tax abatement or reduction, there is no support in the Federal Acquisition Regulations for the conclusion that tax abatements or reductions represent the exhaustive list of exempt taxes(App. 7).

In addition, the court appeals ruled that Judge Futey had erred by supposing that since state income taxes were required to be paid and were paid here, that allowability of this cost inevitably follows under the Federal Acquisition Regulations(App. 7-8). As it ruled,

> the allowable taxes described in 48 CFR Section 31.205-41(a) apply to taxes paid by the contracting party. As an S corporation, ISN never paid any state income taxes. Only Ms. Malkani paid state income taxes on *dividends* paid to her from ISN. Because she is not the contracting party, 48 CFR Section 31.205-41 is inapplicable to Ms. Malkani's state income tax payments. The Court of Federal Claims incorrectly concluded that, because the state income tax liability was not a tax reduction nor an abatement, the state income tax liability could not be an exempt tax under 48 CFR 31.205-41(b).... [But this provision provides] that taxes from which the contracting entity is exempt are not allowable costs. This is the case here. ISN is free from taxation on Ms. Malkani's income derived from ISN's corporate *dividends*. Therefore, in its cost-reimbursement contract, Ms. Malkani's state income tax payments themselves cannot be an allowable cost for ISN.

(App. 7-8;9)(emphasis supplied).

Because the Court of Federal Claims had improperly interpreted 48 CFR 31.205-41(b)'s language about "exemptions" too narrowly and had improperly concluded that Ms. Malkani's state income tax payments ere allowable costs, it reversed the ruling below and remanded the case to that court for further proceedings consistent with that opinion(App. 9-10).

On April 14, 2006, the court of appeals denied the petitioner's timely filed combined petition for panel rehearing or for rehearing *en banc*(App. 31-32). On July 11, 2006, The Chief Justice granted the petitioner's timely filed motion seeking an extension of time to file its petition for certiorari until August 14, 2006.

REASONS FOR GRANTING THE PETITION

1. Denying A Subchapter S Corporation Recovery As Part Of Its Allowable Costs Under Its Reimbursement Contract With The Respondent The Income Taxes Its Sole Shareholder Paid To The State Undermines The Purposes Of The Federal Acquisition Regulations, the Small Business Act, Public Policy and Congress' Intent That The Federal Government Not Use The Reimbursement Scheme To Penalize Those Who Organize Themselves In Business As A Subchapter S Corporation.

The gist of the court of appeals' ruling below is that even though there was an agreement in place between ISN and its sole shareholder, Ms. Malkani, for ISN to reimburse her for any state income tax she was

compelled to pay as the result of ISN's corporate income "passed through" to her on account of its Subchapter S status, it was nevertheless a tax liability founded upon Ms. Malkani's "income derived from ISN's corporate *dividends.*" (App. 7-8)(emphasis supplied). As such, it was a tax liability separate and distinct from ISN which was the contracting party with the government and which is exempt or free from taxation(App.7-9). Thus the court of appeals ruled without citation to any decisional law that Ms. Malkani's state income tax payments themselves cannot be an allowable cost for ISN(App. 9).

This ruling misapprehends the true nature of S corporations as contemplated by Congress when it authorized in the Internal Revenue Code these hybrid corporate structures for use by small businesses in order to avoid the "double taxation" incident to the formation of traditional C corporations. It also misconstrues relevant portions of the Federal Acquisition Regulations in a way that makes every S corporation "exempt" from paying taxes and therefore ineligible for reimbursement for the taxes it actually does pay as a cost of doing business under the government's procurement programs.

More important, this result by the court of appeals undercuts completely Congress' expressed intent in establishing Subchapter S status in the Internal Revenue Code and enacting the Small Business Act (16 U.S.C. Section 631 *et seq.*) of encouraging small businesses such as INS to engage robustly in the Nation's commerce, including the federal government's procurement of goods and services, on the same footing as traditional C

corporations. In fact, the court of appeals' decision serves as a rationale to *penalize* those who organize themselves in business as an S corporation by denying them reimbursement for the state taxes they do pay as a cost of doing business with the government, thereby encouraging these entities to reform themselves as traditional C corporations who will eventually seek and obtain *even larger* reimbursements from the government for the state taxes they pay incident to their cost-reimbursement contracts.

In the first place, in establishing S corporation status in the Internal Revenue Code, Congress provided that while the S corporation itself would not be subject to taxes "imposed by this chapter," corporate income for tax purposes would "pass thru" or be transferred to the corporation's shareholder(s) on a pro rata basis. 26 U.S.C. Sections 1363(a); 1366(a)(1). As Congress provided,

> the character of any item included in a shareholder's pro share...shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation.

26 U.S.C. Section 1366(b).

That is, the S corporation organizational form serves as a conduit for the taxable income of the corporation to flow from the corporate level to the shareholder(s) for purposes of reporting this corporate income on the shareholder's personal income tax return. In this way, the corporation's income and

expenses are "passed through" and taxed to the shareholder(s) at the corporation's year end, regardless of whether the shareholder(s) ever actually receive this corporate income. 26 U.S.C. Sections 1367(a);1368. The essence of the arrangement is *the transfer* of the S corporation's tax liability on its income to the corporation's shareholders on a pro rata basis.

After all, Congress was acknowledging the fact that a small business' decision to incorporate under Subchapter S of the Internal Revenue Code, i.e., to carry on its business in corporate form but without invoking the "double taxation" applied to traditional C corporations, was bottomed on its desire to do business like a partnership but in corporate form without incurring unnecessary tax penalties. See *Klein v. Comm.*, 75 TC 298, 302-303(1980). Indeed, when Congress enacted The Subchapter S Revision Act of 1982, it intended to minimize further the effect of income taxes on the decision to form a business organization by continuing to enable small businesses to have the benefits of incorporation as an S corporation without the incidence of income at both the corporate and shareholder level. See S. Rep. No. 640, 97th Cong., 2d Sess. 5, *reprinted in* 1982 U.S. Cong. & Adm. N. 3253-57.

Judge Futey appreciated this unique taxation scheme by finding that the relationship between an S corporation and its shareholder(s) for tax purposes could not be characterized simply as separate and distinct but rather was a hybrid one which was intermingled and intertwined, i.e., whether a shareholder pays state income tax on corporate income with the corporation reimbursing her or whether the S

corporation itself pays the income tax directly to the state, the S corporation----*not* the shareholder----is subject to potential penalty and/or encumbrance of its ability to do business within that state in the event this tax is not paid by either the corporation or the shareholder.

As the Court of Federal Claims explained, in order to enforce the payment of state income taxes owed by nonresident shareholders, many states require *the S corporation itself* to pay such taxes on behalf of the shareholder(s) either in the form of a corporate-level tax or in the form of a withholding tax. See, e.g., Idaho Code, Section 63.3022(k); La. Rev. Stat. Ann., Section 47:287.732; Okla. Stat., Section 2365; Utah Code Ann., Section 59-7-105(3)(c);Vt. Stat. Ann., Sections 5811 (18), 5823(a); W.Va. Code, Section 11-21-71a(b), (h); Wis. Stat., Sections 71.33, 71.36. These statutorily mandated requirements for an S corporation to conduct business in a particular State confirm Judge Futey's analysis that the S corporation's state tax obligation *begins with the S corporation itself* and is thereafter intermingled and intertwined with its shareholder(s).

It is *not* simply the shareholder's obligation alone to pay the S corporations's state taxes and the court of appeals was wrong to conclude otherwise. Once the true dimensions of the "pass through" nature of the S corporation's income tax liability are acknowledged and ISN's inability to conduct business in a state if its taxes are not paid are recognized, as the Court of Federal Claims did here, it becomes clear that Ms. Malkani's payment of the state tax payments—coupled with ISN's agreement to reimburse her for those state

tax payments—are reasonable, allocable and therefore allowable within the meaning of 48 CFR Sections 31.201-2 *et seq.*

Second, the decision of the court of appeals ignores the plain language of the Federal Acquisition Regulations in a way that makes every S corporation "exempt" from paying taxes and therefore ineligible for reimbursement for the taxes it actually does pay as a cost of doing business under the government's procurement programs. As an initial matter, there is absolutely no support on this record for the court of appeals' surmise that Ms. Malkani was somehow receiving corporate *dividends* for which she was paying state income taxes(App. 7-8;9). Instead, ISN's *corporate income* was being transferred and therefore attributed to Ms. Malkani via the "pass through" provisions of 26 U.S.C. Sections 1366(a) and (b), as mandated by Congress. This revenue generated by ISN under its cost-reimbursement contract with the government is *not* a dividend and the court of appeals' decision to characterize it as such bespeaks a confusion on its part about the true nature of this arrangement for tax purposes and undermines the decision it reached in this matter.

Nor did the court of appeals apply the appropriate standard for construing the term "exemption" in 48 CFR Section 31.205-41(b)(3), to include the "pass through" tax payment arrangement here between ISN and its sole shareholder Ms. Malkani. Just because ISN can "pass through" its income to its sole shareholder Ms. Malkani for income tax purposes under the Internal Revenue Code does not mean that it is "free from taxation" in the sense

that it is "exempt" from tax liability within the meaning of 48 CFR 31.205-41(b)(3). As Judge Futey cogently observed, as an S corporation, ISN "is not relieved of state tax liability [by this arrangement], but is simply required to pass its liability on its corporate income to Ms. Malkani"(App. 22).

This construction of 48 CFR Section 31.205-41(b)(3) by Judge Futey which makes ISN's claim for reimbursement of its state income tax payments allowable under the Federal Acquisition Regulations is correct as a matter of law. The starting point for this regulatory interpretation is the language of the regulations themselves. *Duncan v. Walker*, 533 U.S. 167, 172(2001). *Williams v. Taylor*, 529 U.S. 420, 431(2000). When that regulatory language speaks with clarity, "judicial inquiry into the [regulation's] meaning, in all but the most extraordinary circumstances, is ended." *Estate of Cowart v. Nicklos Drilling Co.*, 505 U.S. 469, 475(1992). See *Robinson v. Shell Oil Co.*, 519 U.S. 337, 340(1997); *Walters v. Metropolitan Ed. Enterprises, Inc.*, 519 U.S. 202, 209(1997).

Moreover, where the plain meaning of a tax regulation cannot be ascertained with sufficient certainty, "the doubt must be resolved *against* the government and *in favor* of the taxpayer." *United States v. Merriam*, 263 U.S. 179, 188(1923)(emphasis supplied). See also *Hassett v. Welch*, 303 U.S. 314(1938). This rule of statutory construction is complemented by the principle that remedial regulations such as 48 CFR Section 31.205-41(b)(3), should be interpreted broadly in order to effectuate obvious Congressional goals. *Northeast Marine Terminal Co. v. Caputo*, 432 U.S. 249, 268(1977). The resulting interpretation should be

one consistent with the taxing statutes viewed as an organic whole. *Brown v. Gardner*, 513 U.S. 115, 118(1994).

Applying these principles of construction, the term "exemption" in 48 CFR Section 31.205-41(b)(3), is strictly construed. *Vill. of Shaumburg v. Citizens for a Better Env't.*, 444 U.S. 620, 644 n. 2(1980). According to 48 CFR Section 31.205-41(b)(3), it means "freedom from taxation in whole or in part and includes a tax abatement or reduction resulting from mode of assessment, method of calculation, or otherwise." However, as Judge Futey found, there was no such "exemption" here.

He found that although INS is technically "exempt" from paying state income taxes on its corporate income because of its S corporation status, it is *not* an exemption in the ordinary sense of that term, i.e., the complete absence of a duty to pay taxes such as when a tax abatement occurs(App. 21-22;28-29). Instead, applying this Court's decisional law that it will look to substance over form in a tax transaction, *Frank Lyon Co. v. United States*, 435 U.S. 561, 573(1978), Judge Futey ruled that INS was relieved of paying state income taxes only because its duty to do so *had not been extinguished but merely transferred* to another entity, its sole shareholder Ms. Malkani, as a result of the "pass through" provisions which characterize this corporate form of small business, as mandated by Congress(App. 21-22). Thus he concluded that INS, "as an S corporation, is not relieved of state tax liability, but is simply required to pass its liability on its corporate income to Ms. Malkani"(App. 22).

As the motion judge ruled, nothing in the Federal Acquisition Regulations requires that any specific part of a corporation pay the applicable state income taxes(App. 22). Instead, it provides that state income taxes which are required to be paid and are paid constitute allowable costs; and because the state taxes here were required to be paid and were paid and "because the tax liability on the corporate income was not subject to abatement or reduction, the state income taxes claimed by the [petitioner] for reimbursement are allowed under the Taxes Provision [of the Federal Acquisition Regulations]"(App. 22). Judge Futey further reasoned that the language forbidding reimbursement when the contractor is "exempt" from the state tax was intended to avoid a "double recovery" by a contractor who is reimbursed by the government for taxes it erroneously paid but does not owe and thereafter receives a refund of the tax from the taxing authorities resulting in a double recovery(App. 29). However, as he noted, there is no danger of a double recovery here because "no refund is available from the state tax authority...[and] the taxes were not erroneously or mistakenly paid but were in fact required to be paid"(App. 29).

Third, the result below undercuts Congress' expressed intent in enacting the Small Business Act, 16 U.S.C. Section 631 *et seq.* The Act encourages small businesses such as INS to engage robustly in the Nation's commerce, including the federal government's procurement of goods and services, on the same footing as traditional C corporations. As Congress found incident to the Act's passage, it was intended to foster "business ownership and development by individuals in groups that own and control little productive

capital..."15 U.S.C. Section 631(d)(2)(B)(I). In addition, Congress has declared that

> it is the continuing policy and responsibility of the Federal Government to use all practical means and to take such actions as are necessary, consistent with its needs and obligations and other essential considerations of national policy, to implement and coordinate all Federal department, agency, and instrumentality policies, programs, and activities in order to: foster the economic interests of small businesses....

15 U.S.C. Section 631a(a). None of these interests is served by affirming the court of appeals' reasoning below.

2. As A Matter Of Equal Protection Of The Laws, This Court Should Rule That The Petitioner, A Subchapter S Corporation, Should Be Allowed Like Any C Corporation To Recover From The Respondent United States As Part Of Its Allowable Costs Under Its Reimbursement Contract The State Income Taxes It Paid.

There is no question on this record that a C corporation would be entitled to reimbursement from the government for the state taxes it paid incident to its performance of a cost-reimbursement contract. That a Subchapter S corporation receives lesser treatment, that pursuant to the decision below it is not entitled to reimbursement for the state taxes it paid, amounts to the kind of disparate, unfair and unequal treatment which bespeaks a denial of the equal protection of the

laws under the fifth amendment to the Federal Constitution. *Allegheny Pittsburgh Coal v. Webster County*, 488 U.S. 336, 343-344(1989). *Kahn v. Shevin*, 416 U.S.351, 355(1974). *Johnson v. Robison*, 415 U.S. 361, 374-375(1974). See *Regan v. Taxation with Representation of Wash.*, 461 U.S. 540, 547(1983); *Carmichael v. Southern Coal Co.*, 301 U.S. 495, 509-510(1937).

While ISN does not face the prospect of double taxation, it nevertheless faces the severely adverse consequence that its state tax liability will be unreimbursed by the government as a result of its election to organize itself as an S corporation. It therefore will have a higher cost of doing business than that of a C corporation in the same circumstances on account of its unallowable, unreimbursed state tax payments. This result, different from that of a C corporation in similar circumstances, is bottomed on no rule of law and constitutes a denial of the equal protection of the laws under the fifth amendment.

As a matter of the equal protection of the laws, then, this Court should rule that the petitioner, a Subchapter S corporation, should be allowed like any C corporation to recover from the government as part of its allowable costs under its cost-reimbursement contract the state income taxes it paid as a cost of doing business with the government.

CONCLUSION

For all of these reasons identified herein, a writ of certiorari should issue to review the judgment of the United States Court of Appeals for the Federal Circuit and, ultimately, to vacate that judgment and remand the matter to the United States Court of Federal Claims with instructions that it reinstate its decision allowing the petitioner to recover as part of its costs under its reimbursement contract with the respondent United States the state income tax payments its sole shareholder paid as part of the business activities related to the contract; or provide the petitioner with such other relief as is fair and just in the circumstances of this case.

Respectfully submitted,
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(any footnotes trail end of each document)
04-5151, 04-5154
UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

INFORMATION SYSTEMS & NETWORKS CORPORATION,
Plaintiff-Cross Appellant,

v.

UNITED STATES,
Defendant-Appellant.

February 6, 2006, Decided

COUNSEL: Norman H. Singer, Singer and Associates, P. C., of Bethesda, Maryland, argued for plaintiff-cross appellant. Of counsel was Benjamin M. Kahrl.

David B. Stinson, Trial Attorney, Commercial Litigation Branch, Civil Division, United States Department of Justice, of Washington, DC, argued for defendant-appellant. With him on the brief were Peter D. Keisler, Assistant Attorney General, David M. Cohen, Director, and Mark A. Melnick, Assistant Director. Of counsel were Gregory T. Allen, Attorney, Defense Contract Management Agency, of Manassas, Virginia, and Raymond J.M. Wong, Attorney, of Alexandria, Virginia.

Thomas M. Abbott, McKenna Long & Aldridge LLP, of Los Angeles, California for amicus curiae United States Chamber of Commerce. With him on the brief was

Mark R. Troy. Of counsel on the brief was Robin S. Conrad, National Chamber Litigation Center, of Washington, DC.

JUDGES: Before RADER, LINN, and PROST, Circuit Judges.

OPINION BY: PROST

OPINION: PROST, Circuit Judge.

This case arose from a dispute over the allowable costs in a cost-reimbursement contract between the United States and Information Systems and Networks Corporation ("ISN"), a Maryland S corporation. The United States Court of Federal Claims granted summary judgment in favor of ISN. It held that, under 48 C.F.R. § 31.205-41, the state income tax payments made by ISN's sole shareholder resulting from dividends received from ISN were allowable costs in the cost-reimbursement contract. Because the Court of Federal Claims improperly interpreted 48 C.F.R. § 31.205-41, we reverse and remand.

I

ISN is a Maryland corporation with one sole shareholder, Roma Malkani. ISN provides services to the United States through cost-reimbursement contracts. Under these contracts, the United States reimburses ISN for allowable costs incurred during performance of the contract. See 48 C.F.R. § 16.301-1 (2004). Each year ISN negotiates with the United States to determine ISN's allowable costs for that year. See 48 C.F.R. § 52.216-7(d)(2)(ii) (2004). A cost is

allowable only when the cost complies with all of the following requirements:

(1) Reasonableness.

(2) Allocability.

(3) Standards promulgated by the CAS Board, if applicable, otherwise, generally accepted accounting principles and practices appropriate to the circumstances.

(4) Terms of the contract.

(5) Any limitations set forth in this subpart.

48 C.F.R. § 31.202-2 (2004). As provided by the last of these requirements, allowable costs must conform to any of the specific limitations set forth in 48 C.F.R. §§ 31.201-205. Many of these limitations are enumerated in 48 C.F.R. § 31.205 and include rules for determining the allowability of forty-seven different types of costs. This case turns on the allowability of certain tax-related costs. Taxes are discussed in 48 C.F.R. § 31.205-41. That subsection states that some but not all taxes paid by an entity are allowable. See 48 C.F.R. § 31.205-41 (2004).

ISN elected to be a subchapter S corporation pursuant to 26 U.S.C. § 1362(a). In a traditional subchapter C corporation, there is what is known as double taxation. A corporation pays income tax on its corporate income. And, when the corporation distributes income to its shareholders, those shareholders also pay income tax on

those dividends. In contrast, an S corporation is only subject to single taxation. The corporation does not pay income tax on the income it generates. Rather, only the shareholders of the S corporation pay income tax on their corporate dividends. As discussed by the Court of Federal Claims,

"S corporations" as they are known, are small businesses, closely held by no more than 75 shareholders, 26 U.S.C. § 1361(b)(1)(A), and often held by a sole shareholder. S corporation status is a tax election designed to make the decision of small businesses to incorporate "tax neutral;" i.e., a business will incur the same tax liability on its income whether the owners of the business incorporate or not. Subchapter S accomplishes this by eliminating the "double taxation" that usually befalls normal corporate income.

Info. Sys. & Networks Corp. v. United States, 48 Fed. Cl. 265, 266 (2000). Many states have aligned their tax codes with the Federal Internal Revenue Code and these states treat S corporations for state income taxes just as the Internal Revenue Code treats S corporations for federal income taxes. In those states that recognize the single taxation of an S corporation, ISN has never paid state income tax. Instead, Ms. Malkani, ISN's sole shareholder, has received dividend income from ISN and Ms. Malkani has paid state income tax on those dividends.

As part of its proposal for reimbursement under its contract with the United States, ISN submitted proposals for reimbursement for costs associated with Ms. Malkani's state income tax payments. The Defense

Council Audit Agency (the "DCAA") denied all of ISN's relevant claims for allowable costs for Ms. Malkani's state income tax payments. The DCAA found that, because ISN was an S corporation and not subject to state income taxes, the state income taxes paid by Ms. Malkani were not allowable costs for ISN. On April 16, 1998, the Contracting Officer issued a final decision denying ISN's claims.

On August 18, 1998, ISN filed suit in the Court of Federal Claims. ISN alleged that it had reimbursed Ms. Malkani for her state income tax and ISN asked the Court of Federal Claims to declare those reimbursements to be allowable costs under the cost-reimbursement contract. The court issued its decision on liability on November 30, 2000. The Court of Federal Claims granted ISN's motion for summary judgment and held that state income tax payments made by ISN's sole shareholder of an S corporation were allowable costs. As allowable costs, ISN was to receive reimbursement for them. As a result, on July 7, 2004, the Court of Federal Claims issued its decision on damages and it held that $ 1,133,176 that had been paid for state income taxes by Ms. Malkani were allowable costs and should be included in the compensation for the cost-reimbursement contract. Info. Sys. & Networks Corp. v. United States, No. 98-663C (Ct. Fed. Cl. July 21, 2004).

The United States filed this appeal on September 10, 2004. This court has jurisdiction to entertain this appeal pursuant to 28 U.S.C. § 1295(a)(3). ISN cross-appeals the Court of Federal Claims' denial of ISN's request for a money judgment as well as interest under the Contracts Dispute Act of 1978. See 41 U.S.C. § 601.

II

This court reviews grants of summary judgment by the Court of Federal Claims de novo. Costain Coal, Inc. v. United States, 126 F.3d 1437, 1440 (Fed. Cir. 1997). "On appeal, this court conducts a 'complete and independent review' of the record to determine whether summary judgment is appropriate." Argent v. United States, 124 F.3d 1277, 1281 (Fed. Cir. 1997) (quoting Tabb Lakes, Ltd. v. United States, 10 F.3d 796, 799 (Fed. Cir. 1993)). A grant of summary judgment is appropriate "'where the record shows 'that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law.'" Id. at 1280.

The Court of Federal Claims concluded that state income taxes incurred by a shareholder of an S corporation are allowable costs. The court reached this conclusion based on its interpretation of both subparts (a) and (b) of 48 C.F.R. § 31.205-41. Discussing which taxes are specifically not allowable, the Court of Federal Claims held that costs are not allowable for "taxes from which exemptions are available to the contractor directly . . . . The term exemption means freedom from taxation in whole or in part and includes a tax abatement or reduction resulting from mode of assessment, method of calculation, or otherwise." 48 C.F.R. § 31.205-41(b) (2004); see also Info. Sys. & Networks, 48 Fed. Cl. at 270. In addition, the Court of Federal Claims noted that subpart (a) of the regulation states that some income taxes are allowable. The regulation states that "the following types of costs are allowable: . . . State . . . taxes . . . that are required to be and are paid . . . ." 48 C.F.R. § 31.205-41(a) (2004); see

also Info. Sys. & Networks, 48 Fed. Cl. at 270. Addressing these two provisions the Court of Federal Claims concluded that the state income taxes claimed by ISN were allowable costs because they were not exempted taxes under 48 C.F.R. § 31.205-41(b) and that they were instead allowable taxes under 48 C.F.R. § 31.205-41(a). The court held that "the state income taxes were required to be paid and were paid, and because the tax liability on the corporate income was not subject to abatement or reduction, the state income taxes claimed by the plaintiff for reimbursement are allowed under the Taxes Provision." Id. We agree with the United States that the Court of Federal Claims' interpretation of the regulation was incorrect.

The language of the regulation makes it clear that the term exemption "means freedom from taxation in whole or in part." 48 C.F.R. § 31.205-41(b) (2004). After stating that general standard, the regulation states that a tax exemption "includes a tax abatement or reduction." Id. There is nothing that supports the Court of Federal Claims' interpretation of the regulation wherein tax abatements and tax reductions represent the exhaustive list of exempt taxes. Tax abatements or tax reductions are not the only types of exempt taxes. Instead, they are only two examples. Furthermore, the Court of Federal Claims also held that "the state income taxes were required to be paid and were paid," and therefore the costs claimed by ISN were allowable under 48 C.F.R. § 31.205-41(a). Info. Sys. & Networks, 48 Fed. Cl. at 270. But this inference is also incorrect. The allowable taxes described in 48 C.F.R. § 31.205-41(a) apply to taxes paid by the contracting entity. As an S corporation, ISN never paid any state income taxes. Only Ms. Malkani paid state income taxes on

dividends paid to her from ISN. Because she is not the contracting entity, 48 C.F.R. § 31.205-41 is inapplicable to Ms. Malkani's state income tax payments. The Court of Federal Claims incorrectly concluded that, because the state income tax liability was not a tax reduction nor a tax abatement, the state income tax liability could not be an exempt tax under 48 C.F.R. § 31.205-41(b).

The Court of Federal Claims' review of various state tax provisions relating to S corporation taxation does not change our view. In discussing those provisions, the court noted that "inspection of the tax codes of the states involved in this case . . . shows that the relationship between an S corporation and its shareholders is an important and intermingled one for state tax purposes." Info. Sys. & Networks, 48 Fed. Cl. at 271. The Court of Federal Claims found that "in general, the state tax codes explain that any corporation which fails to pay its state income taxes, no matter what tax election status it holds, will be subject to penalty and encumbrance on its ability to do business within the state." Id. This, however, is not enough to establish that the tax liability of an S corporation shareholder is an allowable cost for the corporation. In fact, the Court of Federal Claims' characterization of these state tax provisions suggests, though not conclusively, the opposite result. As the reviewed state tax liabilities are described as penalties and encumbrances, this suggests that these costs are generally not allowable costs. Another subpart of the regulations discusses the allowability of penalties:

Costs of fines and penalties resulting from violations of, or failure of the contractor to comply with, Federal, State, local, or foreign laws and regulations, are

unallowable except when incurred as a result of compliance with specific terms and conditions of the contract or written instructions from the contracting officer.

48 C.F.R. § 31.205-15(a) (2004). The Court of Federal Claims' reliance on state tax provisions that describe penalties for failure to have shareholders pay the proper state income tax does not establish that an S corporation shareholder's state income tax payments should be an allowable cost to the corporation.

The plain language of 48 C.F.R. § 31.205-41(b) states that taxes from which the contracting entity is exempt are not allowable costs. This is the case here. ISN is free from taxation on Ms. Malkani's income derived from ISN's corporate dividends. Therefore, in its cost-reimbursement contract, Ms. Malkani's state income tax payments themselves cannot be an allowable cost for ISN.

III

For the reasons stated, the Court of Federal Claims improperly interpreted 48 C.F.R. § 31-205-41(b) too narrowly and it therefore improperly concluded that Ms. Malkani's state income tax payments were allowable costs. This court reverses the Court of Federal Claims' grant of summary judgment in favor of ISN and remands the case to the Court of Federal Claims for further proceedings consistent with this opinion. As this court reverses the grant of summary judgment, ISN's counterclaim for money damages and interest is rendered moot.

COSTS

No costs.

REVERSE AND REMAND

No. 98-663C

UNITED STATES COURT OF FEDERAL CLAIMS

INFORMATION SYSTEMS & NETWORKS CORPORATION,
Plaintiff,

v.

THE UNITED STATES,
Defendant.

November 30, 2000, Filed

COUNSEL: Norman H. Singer, Bethesda, Maryland, attorney of record for plaintiff. A. Daniel Ullman II, of counsel.

Erin E. Powell, Department of Justice, Washington, D.C., with whom was Acting Assistant Attorney General David W. Ogden, for defendant. David M. Cohen, Director, and Mark A. Melnick, Assistant Director.

JUDGES: BOHDAN A. FUTEY, Judge.

OPINIONBY: BOHDAN A. FUTEY

OPINION:

Futey, Judge.

This case is before the court on the parties' cross-motions for summary judgment. Plaintiff Information Systems & Networks Corporation appeals from the

final decision of the Contracting Officer (CO) denying plaintiff's claims for reimbursement of state income taxes paid on income derived from government cost-reimbursement and time-and-materials contracts. Plaintiff asks for a declaratory judgment from this court stating that (1) payment of state income taxes by its sole shareholder on behalf of plaintiff, a Subchapter S corporation, is a reimbursable, allowable cost under the Federal Acquisition Regulations (FAR); and (2) such payment should be allowed to be included in plaintiff's indirect rate cost pool for the contracts performed by plaintiff for the United States government (defendant). Plaintiff also asks for attorney fees and costs. Plaintiff argues that the pertinent provisions of the FAR regarding allowability of costs, and specifically of taxes paid, apply in favor of plaintiff and its sole shareholder because (1) the FAR provisions were intended to include such tax reimbursement; and (2) an agreement between plaintiff and its sole shareholder obligated plaintiff to reimburse the sole shareholder for the taxes (Agreement), therefore creating a valid and reasonable cost to plaintiff that is reimbursable under the FAR. Defendant contends that because plaintiff is an S corporation, its income tax liability is "passed through" to the sole shareholder, and therefore plaintiff did not have to pay, nor did it pay, state income taxes as a result of the contracts at issue. Defendant argues instead that the tax liability belonged exclusively to the sole shareholder, and as such is personal liability that is not reimbursable under the FAR.

Factual Background

Plaintiff is a corporation organized under Subchapter S of the Internal Revenue Code (IRC), *26*

U.S.C. § § 1361-1379 (1994 & Supp. V 1999). "S corporations," as they are known, are small businesses, closely held by no more than 75 shareholders, *26 U.S.C. § 1361* (b)(1)(A), and often held by a sole shareholder. S corporation status is a tax election designed to make the decision of small businesses to incorporate "tax neutral;" i.e., a business will incur the same tax liability on its income whether the owners of the business incorporate or not. Subchapter S accomplishes this by eliminating the "double taxation" that usually befalls normal corporate income. *See 26 U.S.C. § 1363.* With an ordinary corporation, or "C corporation," the corporate entity must pay income taxes on its income. Then, when the corporation distributes after-tax income to its shareholders, those shareholders must pay personal income tax on that source of income. In the case of an S corporation, no income tax liability accrues to the corporation. Instead, the corporation's income is "passed through" to the shareholders, and is attributed to the shareholders' personal income tax liability in pro rata amounts. *26 U.S.C. § 1366.* States have the option of recognizing the federal S corporation designation by aligning their tax codes with the IRC to allow the transfer of income tax liability of the corporation to the personal tax liability of the shareholders. Most states have adopted the same treatment of S corporations as the federal government. The state income taxes for which plaintiff has asked reimbursement from the government all were imposed in states that have adopted the S corporation tax treatment found in the IRC. n1

Plaintiff has a sole shareholder, Roma Malkani, and therefore the entire income tax liability of plaintiff is passed through to her personal income tax liability.

Plaintiff alleges that it and Ms. Malkani, however, entered into the Agreement, referenced above. In accordance with the Agreement, Ms. Malkani has indeed paid the state income taxes incurred by plaintiff on her own income tax returns, but pursuant to a regular course of practice has been reimbursed by plaintiff for the payment of those taxes. Defendant claims that plaintiff has not satisfactorily proven the existence of the Agreement, as it is mentioned only in an affidavit and a deposition, and plaintiff has provided no written memorialization of the Agreement. Defendant does not dispute, however, that Ms. Malkani paid the taxes at issue, and that plaintiff reimbursed her for such tax payment.

Plaintiff and defendant entered into several cost-reimbursement and time-and-materials contracts in the 1980's and early 1990's. These types of contracts provide a cost ceiling for the work performed on a contract and permit the government to pay up to that ceiling amount for allowable incurred costs of the contractor for the contract work. *48 C.F.R. § 16.301-1 (2000)*. This arrangement is made for contracts for which the contract price is not readily ascertainable at the time of contracting. Id. During performance of one of these contracts the contractor incurs direct (e.g., materials, labor, equipment costs) and indirect (e.g., taxes, rental space, insurance) costs. Both direct and indirect costs are generally allowable for reimbursement. *48 C.F.R. § 31.201-1(a) (2000)*. After performance, a contractor requests reimbursement for indirect costs via an "indirect rate proposal," which relates back to the agreed-upon rates for allowable costs for that certain type of contract. This proposal requests that the various claimed costs be included in

the "rate pool." n2 The government then determines what costs are allowable, determines the proper contents of the rate pool, adjusts the rate of reimb rsement accordingly, and pays the contractor for its all(vable costs.

Plaintiff submitted final indirect rate proposals for fiscal years (FY) 1985-91. It claimed reimbursable expenses for state income taxes paid in each of those proposals within its "general and administrative expense rate pool." Plaintiff relied on information from outside sources that other S corporations had been reimbursed for state income taxes in this manner. n3 In each case, excepting FY 1990, the Defense Contract Audit Agency (DCAA), which processed the proposals, denied plaintiff's claims for state income taxes, explaining that the taxes paid were unallowable. n4 DCAA based its decision on the fact that plaintiff was an S corporation, and therefore was not subject to state income tax:

> The contractor is a Sub-Chapter S Corporation. As such, with few exceptions, the corporation is not taxed by the states on its income; rather the income flows to the stockholders who pay tax on their personal income tax returns. Thus, this is a personal tax expense to the shareholders. The state income taxes of individuals are not allocable to the company, as described in [*48 C.F.R. §] 31.201-4*, Determining allocability, and therefore, are not part of the contract costs directly or indirectly. n5

Despite continuing correspondence between the parties, plaintiff and defendant reached an impasse

concerning the reimbursement of the state income taxes. After the DCAA disallowances of tax costs, plaintiff twice requested a final decision from the CO concerning its indirect rate proposals for reimbursement of taxes. n6 On April 16, 1998, the CO issued a final decision denying plaintiff's claims for FY 1985 and 1986, and demanded repayment of previous reimbursement to plaintiff that it deemed as unallowable costs. n7 On August 18, 1998, plaintiff filed suit in this court, asking the court to declare the taxes paid by Ms. Malkani, and subsequently reimbursed by plaintiff, to be allowable under the pertinent provisions of the FAR. Defendant counterclaimed, asking for the return of its previous improper reimbursement of a portion of plaintiff's incurred state income taxes. The parties proceeded to file motions for summary judgment in this matter.

Discussion

Plaintiff asks for declaratory judgment in this case. As a general rule, this court does not have jurisdiction over such claims, and does not have the authority to issue declaratory judgments. *See 28 U.S.C. § 2201* (1994) (stating only a "court of the United States" can issue declaratory judgments); *28 U.S.C. § 451* (1994) (excluding the Court of Federal Claims from the definition of "court of the United States"). In 1992, however, this court's jurisdiction was enlarged by amendment of the Tucker Act, the court's jurisdictional foundation. The Tucker Act, *28 U.S.C. § 1491*(a)(2) (1994), now states that the court has jurisdiction to render judgment on nonmonetary claims brought in this court under section 10(a)(1) of the Contract Disputes Act of 1978 (CDA), *41 U.S.C. § 609*(a)(1) (1994), based on denials of contractor claims to CO's

under section 6 of the CDA, *41 U.S.C. § 605* (1994 & Supp. III 1997). A complaint for declaratory judgment appealing a denial of claims by a CO's final decision falls within the court's jurisdiction over "nonmonetary claims." *Emery Worldwide Airlines, Inc. v. United States, 47 Fed. Cl. 461, 468 (2000); see Alliant Techsystems, Inc. v. United States, 178 F.3d 1260, 1268 (Fed. Cir. 1999).*

In this case, plaintiff appeals a final decision by the CO under section 6(a) of the CDA denying reimbursement for the taxes paid in FY 1985 and 1986, and appeals a deemed denial (due to the CO's failure to issue a final decision within 60 days) of its claims for taxes paid FY 1987-91 under section 6(b)(5) of the CDA. It has brought its claims in this court under section 10(a)(1) of the CDA. This court has jurisdiction, therefore, over plaintiff's claims for declaratory judgment.

I. Summary Judgment

The parties have filed cross-motions for summary judgment. Summary judgment is appropriate when there are no genuine issues of material fact and the moving party is entitled to judgment as a matter of law. RCFC 56(c); *Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 247, 91 L. Ed. 2d 202, 106 S. Ct. 2505 (1986), cited in Jay v. Secretary, DHHS, 998 F.2d 979, 982 (Fed. Cir. 1993).* A fact is material if it might significantly affect the outcome of the suit under the governing law. *Anderson, 477 U.S. at 248.* The fact that both parties have moved for summary judgment does not relieve the court of its responsibility to determine the appropriateness of summary disposition. *Prineville Sawmill Co. v. United States, 859 F.2d 905, 911 (Fed.*

Cir. 1988)(citing *Mingus Constructors, Inc. v. United States, 812 F.2d 1387, 1390 (Fed. Cir. 1987)).* A cross-motion is a party's claim that it alone is entitled to summary judgment. *A Olympic Forwarder, Inc. v. United States, 33 Fed. Cl. 514, 518 (1995).* It does not follow that if one motion is rejected, the other is necessarily supported. *Id.* Rather, the court must evaluate each party's motion on its own merit and resolve all reasonable inferences against the party whose motion is under consideration. *Id.* (citing *Corman v. United States, 26 Cl. Ct. 1011, 1014 (1992)).*

FAR Part 31, Contract Cost Principles and Procedures, Subpart 31.2, Contracts With Commercial Organizations, establishes a set of principles and provisions for the reimbursement of costs for contractors performing the type of contract at issue in this case. The section named "Determining allowability" states that costs generally must meet two criteria in order to be an allowable expense: first, the cost must be reasonable, and second, it must be allocable. *48 C.F.R. § 31.201-2(a)(1)*,(2) (2000). The "Determining reasonableness" provision states that a cost is reasonable when it is incurred in accord with sound, generally accepted business principles, and that a prudent person engaged in a competitive business would expect to incur such cost ordinarily and necessarily when completing contract work for the government. *48 C.F.R. § 31.201-3 (2000).* In the "Determining allocability" section, the FAR provides that the amount claimed must be chargeable generally to a cost objective of the contractual relationship between the contractor and the government in order to be allocable and therefore reimbursable. *48 C.F.R. § 31.201-4(a),* (b) (2000). Subsection (c) of the provision

states, however, that expenses which are not directly attributable to contract work, but nonetheless are necessary for the overall operation of the contractor's business, are allocable. § 31.201-4(c). The government will make payments for reimbursement costs only when a claimant shows that such costs are allowable. *48 C.F.R. § 52.216-7 (2000).*

In addition, specifically provided in the FAR provisions regarding reimbursement is the section entitled "Taxes," which provides the basis for the reimbursement of certain tax expenditures of contractors performing cost-reimbursement contracts for the government. *48 C.F.R. § 31.205-41 (2000)* (Taxes Provision). The section states that certain federal, state and local taxes are allowable if they "are required to be and are paid or accrued in accordance with generally accepted accounting principles." § 31.205-41(a)(1). State income taxes in general are allowable costs under the section. *See* § 31.205-41(a), (a)(1), (b). If the contractor is exempt from a certain tax liability, however, and still proceeds to pay such tax, that tax expenditure is not allowable. § 31.205-41(b)(3).

Plaintiff argues first that the Taxes Provision intends to compensate for taxes paid by all types of "commercial organizations," including S corporations, because Subpart 31.2 applies to all such organizations, and nothing in any of the reimbursement sections states that certain organizations would be treated differently from others. Second, plaintiff maintains that it is required by state law to ensure the timely and appropriate payment of taxes required of Ms. Malkani due to plaintiff's business activities and corporate income, otherwise its corporate charter could be forfeited. Plaintiff avers that it executed the

Agreement with Ms. Malkani under which plaintiff paid Ms. Malkani for her personal income taxes incurred on plaintiff's corporate income. n8 Plaintiff therefore asserts that (1) the tax itself had to be paid by Ms. Malkani; (2) plaintiff was required to pay for the expense equal to the additional tax burden of Ms. Malkani; and (3) the expenditure incurred pursuant to the Agreement is reasonable and allocable, because it was necessary to maintain its charter and therefore its ability to continue performing work on its contracts with the government.

Defendant responds simply that the state law applicable to this case places the ultimate responsibility to pay the pass-through income taxes on plaintiff's corporate income squarely on Ms. Malkani; it concludes, therefore, that an S corporation has no responsibility to pay state income taxes or ensure such payment. According to defendant, because plaintiff did not have to pay state income taxes, plaintiff's claims for reimbursement are not allowable under the Taxes Provision, nor is such payment reasonable or allocable under the general provisions regulating reimbursement.

The court must first determine if the Taxes Provision was meant to allow reimbursement of state income taxes paid as a result of plaintiff's performance of government contracts, even if plaintiff itself was not technically required to pay the taxes. There is little in the way of guidance on this question. When the court undertakes interpretation of a federal regulation, it will rely first on its plain language. *PCA Health Plans of Texas v. LaChance, 191 F.3d 1353, 1355 (Fed. Cir. 1999).* Also, the court will accord some deference to the

construal of the regulation by an agency's board of appeals, when such board possesses particular expertise in determining the meaning of the regulation. *Titan Corp. v. West, 129 F.3d 1479, 1481 (Fed. Cir. 1997).* n9

The language of the Taxes Provision states that when a contractor pays taxes from which it is exempt, the contractor will not qualify for reimbursement for the tax payment:

> (b) The following types of costs are not allowable:
>
> . . . .
>
> (3) Taxes from which exemptions are available to the contractor directly . . . . The term *exemption* means freedom from taxation in whole or in part and includes a tax abatement or reduction resulting from mode of assessment, method of calculation, or otherwise.

48 C.F.R. § 31.205-41(b), (b)(3). Although technically plaintiff is "exempt" from paying state income taxes due to its S corporation status, this is not a tax exemption in the normal sense of the term. Usually when an entity or individual is exempt from taxation, the result is the complete absence of payment of that tax, either by the exempted party or any other party. This absence of payment requirement is embodied in the term "abatement" included in the exemption definition in the Taxes Provision. § 31.205-41(b)(3). n10 In plaintiff's

situation, however, the exemption is not an abatement of tax liability, but a transfer of liability. Plaintiff, as an S corporation, is not relieved of state tax liability, but is simply required to pass its liability on its corporate income to Ms. Malkani. The Taxes Provision's language does not require that any specific part of a corporation pay the state income taxes: "The following types of costs are allowable: . . . States . . . taxes . . . that are required to be and are paid . . . ." § 31.205-41(a), (a)(1). Because the state income taxes were required to be paid and were paid, and because the tax liability on the corporate income was not subject to abatement or reduction, the state income taxes claimed by plaintiff for reimbursement are allowed under the Taxes Provision. n11

This interpretation of the Taxes Provision comports with the general intent of the FAR and the IRC. Nothing in the FAR provisions involved in this case points to an intent that certain types of commercial organizations should be denied reimbursement altogether simply because of their tax election or corporate structure. Nor does the purpose behind Subchapter S of the IRC include any desire that the structure of pass-through taxation would cause a corporation to lose out on reimbursement due to its tax election. Neither the FAR nor Subchapter S state that an S corporation is only allowed one type of tax relief, either pass-through taxation or cost-reimbursement. Indeed, S corporations are small businesses and their corporate structure is meant to help, not hinder, the growth and health of these businesses. It is the general intent of the FAR to aid and encourage small businesses as well. n12

In addition, to interpret the provision in this way does not frustrate the purpose of reimbursement. There is no question that the taxes have been paid, nor that the reimbursement sought by plaintiff is meant precisely to cover that payment. Also, the government will completely discharge its duty to reimburse when it pays the costs of these taxes, even though the money will go directly to plaintiff, and not Ms. Malkani. This reimbursement is especially justified when, as in this case, an S corporation has first reimbursed its shareholder for the payment of taxes. In addition, it seems that other S corporations have been reimbursed in exactly the same way as plaintiff is asking here. Ms. Malkani paid the income taxes incurred by plaintiff. Plaintiff recompensed Ms. Malkani for such payment. Pursuant to the Taxes Provision, therefore, defendant is obligated to reimburse plaintiff for this transferred pass-through tax expenditure. n13

Defendant nevertheless relies upon the obvious general proposition that because only the shareholders of an S corporation are required to pay taxes on corporate income, and not the corporation itself, the two tax liabilities are completely separate. Defendant therefore asserts that plaintiff has no basis for requesting reimbursement for the tax expenditures of Ms. Malkani. Inspection of the tax codes of the states involved in this case, however, shows that the relationship between an S corporation and its shareholders is an important and intermingled one for state tax purposes. The most useful examples of this relationship exist in the provisions concerning nonresident shareholders. *E.g., Va. Code Ann. § 58.1-332(C)* (Michie 1997).

To begin, the states require an S corporation to file a tax return for its corporate income, despite the fact that the corporation will never pay taxes on such income. *E.g., N.C. Gen. Stat. § 105-131.7(a)* (1999). With its return, an S corporation in many states must file agreements by its nonresident shareholders that they will pay their share of the income taxes incurred by the corporation. *N.C. Gen. Stat. § 105-131.7(c)(i)*; *R.I. Gen. Laws § 44-11-2(d)(3)* (1995); *Ga. Code Ann. § 48-7-27(d)(2)* (1995). Other states require the corporation to furnish extensive information on each shareholder. *S.C. Code Ann. § 12-8-590(B)* (Law. Co-op. Supp. 1999). Shareholders must in some cases subject themselves explicitly to personal jurisdiction in the state in order for the S corporation to enjoy pass-through taxation status. *N.C. Gen. Stat § 105-131.7(c)(ii)*; *S.C. Code Ann. § 12-8-590(F)(3)*. Some tax codes provide that if an S corporation fails to file such agreements, the S corporation must pay a penalty. *Ga. Code Ann. § 48-7-129(a)(3)* (1995 & Supp. 1999). In some circumstances, certain tax codes require an S corporation to withhold state taxes on behalf of nonresident shareholders, and arrange for reimbursement from these shareholders at a later date. Md. Code Ann. Tax § 10-102.1(b)(1), (2), (c) (1997); *Ga. Code Ann. § 48-7-129(a)(1)*; *S.C. Code Ann. § 12-8-590(A)*; *Ind. Code § 6-3-4-13* (1996); Ind. Admin. Code tit. 45, r. 3.1-1-66 (1992); *Ind. Code § 6-8.1-10-2.1(h)* (1996) (penalties levied for failure to withhold). Others actually require the corporation to pay the corporate income taxes automatically, or if the shareholder fails to pay. *N.C. Gen. Stat § 105-131.7(c)*; *R.I. Gen. Laws § 44-11-2(d)(4)(i)*-(ii); Ind. Admin. Code tit. 45, r. 3.1-1-109 (1992). In general, the state tax codes explain that any corporation which fails to pay its state income

taxes, no matter what tax election status it holds, will be subject to penalty and encumbrance on its ability to do business within the state. *See, e.g., Md. Code Ann. Corps. & Ass'ns § 3-503(a)(1),* (2) (1997); *Ohio Rev. Code Ann. § 5733.20* (Anderson 1999). n14 The obligations of an S corporation and its shareholders to pay state income taxes are therefore closely intertwined, and an S corporation is very much required to ensure the payment of its state income taxes. The rigid argument that the tax liabilities of plaintiff and Ms. Malkani are completely separate does not suffice to prohibit reimbursement. Defendant is therefore obligated to reimburse plaintiff for the necessary expenditure plaintiff makes and has made to ensure the payment of its incurred state income taxes.

Conclusion

For the above-stated reasons, the Taxes Provision, *48 C.F.R. § 31.205-41,* allows an S corporation to recover costs associated with the payment of state income taxes incurred on its corporate income. The state tax expenditures incurred by plaintiff on its business activities related to its cost-reimbursement contracts with defendant are therefore reimbursable under the FAR. Plaintiff's motion for summary judgment is granted. Defendant's cross-motion for summary judgment is denied. Pursuant to this holding, defendant's counterclaim for the return of its previously paid state income tax reimbursement to plaintiff is dismissed.

The parties are directed to file a joint stipulation as to the amount of taxes to be reimbursed in accordance with this ruling no later than December 28, 2000. The Clerk is directed to enter judgment in the amount

stipulated without further order of the court. Plaintiff's claim for attorney fees and costs is denied without prejudice at this time. Plaintiff may file its brief requesting attorney fees and costs pursuant to the Equal Access to Justice Act, *28 U.S.C. § 2412* (1994 & Supp. IV 1998). No costs.

IT IS SO ORDERED.

BOHDAN A. FUTEY

Judge

n1 These states are Maryland, Ohio, Indiana, Georgia, Virginia, Rhode Island, North Carolina and South Carolina.

n2 Claims for state income taxes are included within a contractor's proposed "general and administrative expense rate pool."

n3 Ms. Malkani, in her capacity as plaintiff's president, explained in a letter to the CO that DCAA had previously allowed state income taxes paid by S corporation shareholders as costs. Ms. Malkani stated that DCAA had allowed as costs the state income taxes of Executive Resource Associates, Inc., another S corporation. Plaintiff's/Counterclaim Defendant Information Systems & Networks Corporation's Motion for Summary Judgment, Appendix, Exhibit 8, Letter of May 2, 1996 from Ms. Malkani to the CO.

n4 Plaintiff claimed only $ 404 in FY 1990 for reimbursement of state income taxes, and therefore DCAA considered it an insignificant amount and allowed the claim. DCAA disallowed the tax costs for FY 1985 and 1986 on November 1, 1994, and disallowed the tax costs for FY 1987-89 and 1991 on May 23, 1995.

n5 Defendant's Cross-Motion for Summary Judgment and Opposition to Plaintiff's Motion for Summary Judgment, Appendix, Exhibit 3, DCAA Audit Report of Nov. 1, 1994.

n6 Plaintiff requested reimbursement in the amount of $ 294,052 in the second request for final decision, and certified the claim under *48 C.F.R. § 52.233-1 (2000)*, as the claim amounted to more than $ 100,000.

n7 The CO directed plaintiff to pay $ 262,515, with $ 17,274 of the total representing unallowable state income tax reimbursement for FY 1985 and 1986.

n8 Although defendant questions whether the Agreement actually exists, the fact that this Agreement was never executed would not change the court's analysis. The operative fact is not whether plaintiff agreed to reimburse Ms. Malkani for the payment of the pass-through corporate income taxes, but is instead whether plaintiff actually did reimburse Ms. Malkani for those tax payments. It is not disputed that Ms. Malkani paid the state income taxes at issue in this case, nor that plaintiff reimbursed Ms. Malkani for these payments.

n9 Unfortunately, few board of appeal decisions have attempted to interpret the Taxes Provision. Although none has dealt specifically with the issue of whether state income taxes are allowable for S corporations, the General Services Board of Contract Appeals (GSBCA) has heard claims for such reimbursement. At no time in the resolution of those claims has the GSBCA made any reference to a blanket prohibition on the allowability of state income taxes for S corporations due to the pass-through nature of their tax liability, and has instead treated S corporations in no special manner on claims for reimbursement of such taxes. *See, e.g., Singleton Contracting Corp., 1990 GSBCA LEXIS 309, 90-3 B.C.A. (CCH) P23,125*, GSBCA No. 9614 (June 1, 1990).

n10 Abatement, as applied to the payment of taxes, is thus defined: "Diminution or decrease in the amount of tax imposed. Abatement of taxes relieves property of

its share of the burdens of taxation after the assessment has been made and the tax levied." Black's Law Dictionary 4 (5th ed. 1979). In this case, the property involved, plaintiff's corporate income, has not been relieved of its tax burden. Instead, the property is taxed through Ms. Malkani's personal tax liability instead of plaintiff's corporate tax liability.

n11 Indeed, the restriction in the Taxes Provision, precluding allowance of taxes when the contractor is exempt from such tax, § 31.205-41(b)(3), is most likely primarily to preclude a contractor's double recovery of taxes. A contractor that unnecessarily pays taxes to a state will undoubtedly be able to recover those payments in refunds from the state. The reimbursement of such erroneous payments as contract costs as well would unjustly enrich a contractor, therefore, as the contractor could recover the same amount from the government, as costs, and from the state tax authority, as refunds. The Taxes Provision merely cuts off the chance for such double recovery. Subsection (b)(3) of the Taxes Provision is complemented by subsection (d), which states that any taxes later refunded to a contractor from the taxing entity will be returned to the government when the government had previously reimbursed such taxes as allowable costs. In this case, however, no refund is available from the state tax authority. The taxes were not erroneously or mistakenly paid, but in fact were required to be paid. No double recovery is available here, and therefore the taxes are allowable costs under the Taxes Provision.

n12 As another policy issue, a finding by this court that the Taxes Provision precludes allowability of state

income taxes paid by shareholders of S corporations would most likely harm the financial interests of the federal government in the future. Government contractors that elect S corporation status pay taxes on corporate income at a lower rate than normal C corporations. If the Taxes Provision does not allow reimbursement for state income taxes for S corporations, such corporations will most likely change their tax election to C corporation status in order to benefit from the cost reimbursement available from the Taxes Provision. This change in election would cause these government contractors to be taxed at the higher C corporation rates, and therefore the amount the federal government will be required to reimburse will be higher as a result.

n13 The parties also dispute whether the general provisions concerning reasonableness, *48 C.F.R. § 31.201-3*, allocability, *48 C.F.R. § 31.201-4*, and allowability, *48 C.F.R. § 31.201-2*, require defendant's reimbursement of plaintiff's repayment to Ms. Malkani for her payment of plaintiff's incurred income taxes under the Agreement. Because the more specific Taxes Provision allows for such reimbursement, however, the court need not enter into this discussion in order to rule properly in this case.

n14 This discussion is not meant to apply these statutory provisions directly to plaintiff's situation; instead, it illustrates an overall unseparated approach to the tax liability of S corporations and their shareholders in the states involved in this case.

04-5151, 04-5154

UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

INFORMATION SYSTEMS & NETWORKS CORPORATION,
Plaintiff-Cross Appellant,

v.

UNITED STATES,
Defendant-Appellant.

April 14, 2006, Decided

April 14, 2006, Filed

NOTICE: THIS DECISION WAS ISSUED AS UNPUBLISHED OR NONPRECEDENTIAL AND MAY NOT BE CITED AS PRECEDENT. PLEASE REFER TO THE RULES OF THE FEDERAL CIRCUIT COURT OF APPEALS FOR RULES GOVERNING CITATION TO UNPUBLISHED OR NONPRECEDENTIAL OPINIONS OR ORDERS.

OPINION: ORDER

A combined petition for panel rehearing and for rehearing en banc having been filed by the Cross-Appellant, and the petition for rehearing, having been referred to the panel that heard the appeal, and thereafter the petition for rehearing en banc having been referred to the circuit judges who are in regular active service,

UPON CONSIDERATION THEREOF, it is

ORDERED that the petition for panel rehearing be, and the same hereby is, DENIED and it is further

ORDERED that the petition for rehearing en banc be, and the same hereby is, DENIED.

The mandate of the court will issue on April 21, 2006.

United States Constitution, Article I, Section 8:

The Congress shall have the Power To lay and collect Taxes....

United States Constitution, Amendment V:

No person shall...be deprived of life, liberty, or property, without due process of law....

United States Constitution, Amendment XVI:

The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived.....

48 CFR Section 31.201-1(a)(Contracts with Commercial Organizations):

The total cost, including standard costs properly adjusted for applicable variances, of a contract is the sum of the direct and indirect costs allocable to the contract....

48 CFR Section 31.201-2 (Determining allowability):

(a) A cost is allowable only when the cost complies with all of the following requirements:

(1) Reasonableness.

(2) Allocability.

(3) Standards promulgated by the CAS Board, if applicable, otherwise, generally accepted accounting principles and practices appropriate to the

circumstances.

(4) Terms of the contract.

(5) Any limitations set forth in this subpart....

48 CFR Section 31.201-3(a) (Determining reasonableness):

A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business....

48 CFR Section 31.201-4(a) (Determining allocability):

A cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship...[and] is incurred specifically for the contract...or is necessary for the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown.

48 CFR Section 31.205-15(a) (Fines, penalties and mischarging costs):

Costs of fines and penalties resulting from violations of, or failure of the contractor to comply with, Federal, State, local, or foreign laws and regulations, are unallowable except when incurred as a result of compliance with specific terms and conditions of the contract or written instructions from the contracting officer.

48 CFR Sections 31.205-41(a)(1) and (b)(3) (Taxes):

(a) The following types of costs are allowable:

(1) Federal, State, and local taxes...that are required to be and are paid or accrued in accordance with generally accepted accounting principles....

....

(b) The following types of costs are not allowable:

....

(3) Taxes from which exemptions are available to the contractor directly, or available to the contractor based on an exemption Afforded the Government....The term *exemption* means freedom from taxation in whole or in part and includes a tax abatement or reduction resulting from mode of assessment, method of calculation, or otherwise.

(emphasis in original).